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THE DOLLAR AND U.S. TRADE

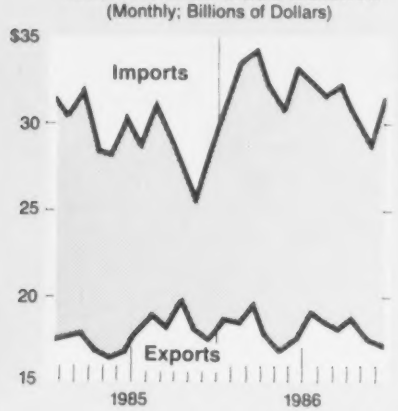
The exchange rate of the dollar against most other major currencies has been declining more or less steadily since early 1985. Relative to the German mark and the Japanese yen, the dollar's decline has been unmatched by any major currency during the post-World War II period. At the same time—and against all predictions—the U.S. trade deficit has stubbornly refused to shrink.

Over the past two years, the trade deficit has failed to narrow, whether on an overall basis (Chart 1) or in terms of our major trading partners. The bilateral deficit with Japan alone, for example, accounted for over one-third of the total 1986 deficit. While the most recent data can be interpreted as suggesting that the trade balance is no longer worsening, clear evidence of an actual turnaround has yet to emerge. On the other hand, German and Japanese exports have already suffered because of the sharp appreciation of the mark and the yen.

Chart 1

United States Trade Balance

(Monthly; Billions of Dollars)



More important, when measured in *constant* dollars—which form one of the key components of the U.S. national accounts—exports in 1986 showed much smaller gains than imports (Chart 2). For the year as a whole, exports of agricultural products in constant dollars were unchanged from 1985; those of nonagricultural products were up by some $10 billion; and imports of nonpetroleum products were up by $35 billion. As a result, almost one-third of last year's increase in domestic demand leaked abroad through the deterioration in the U.S. trade position and reduced the growth of GNP accordingly. However, this trend appears to have been reversed toward the end of 1986.

Is there an inherent contradiction between the behavior of the dollar and that of the trade figures? Ought there to be greater correspondence between the two? Or are we looking at two largely independent phenomena, at numbers that are related much less than we have tended to assume?

The Nature of U.S. Trade Data

The nature of the monthly trade data is such that they bear little resemblance to a given month's actual trade and even less to the dollars earned by foreign suppliers. The import data, moreover, tend to overstate what we "owe" foreigners, so that it is incorrect to draw firm conclusions for the dollar from the monthly figures.

The monthly trade data that are eagerly awaited and then linked to that day's movements in the dollar—a typical headline might read "Dollar Higher on Better Trade Figures"—are based on a somewhat artificial statistical construct. These numbers—the trade data—reflect neither the actual movement of goods into and out of the United States nor payments for exports and imports. The connection between a given month's trade deficit and what we "owe" foreigners because of that deficit is therefore rather tenuous. So are the implications for the dollar's level.

What do the trade figures actually reflect? The Census Bureau's monthly merchandise trade statistics are obtained from shippers' export declarations and from import entry forms filed with Customs. The pub-

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Chart 2
Merchandise Exports and Imports
(Billions of 1982 Dollars; Annual Rates)

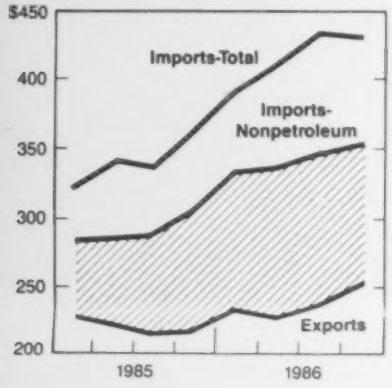
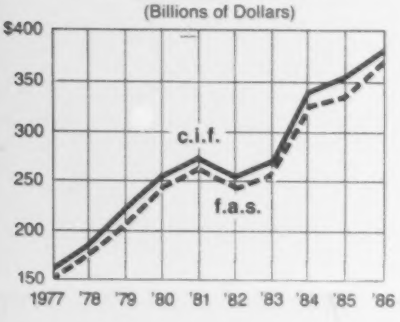


Chart 3
United States Imports
(Billions of Dollars)



The Decline of the Dollar

lished data for what the Commerce Department calls a "statistical month" simply reflect those export and import documents that are *processed* during a period running from the 15th of the preceding to the 15th of the following month. There could be a "month" during which very little merchandise moved because, for example, of a country-wide maritime strike; yet the data (the documents processed) might show a sizable trade deficit. Would the dollar then weaken, on the basis of those statistics?

According to the Commerce Department, a measure "that more closely approximates the actual month of release of imported merchandise by Customs and of the shipment of exports" is published only after a two-month lag. Data reflecting the *actual* months of entry for imports, and of shipment for exports, are compiled only once a year and published during the third quarter of the following year. Thus, what the dollar often reacts to is a set of statistics that bears little semblance to actual trade and even less to the accumulation of additional dollar balances by foreigners (the so-called dollar outflow) occasioned by our trade deficit.

But even if the published data did correspond to actual trade flows, they still would not be an accurate indicator of what foreigners earn from what they sell to us. Since 1980, the Commerce Department has been publishing the monthly trade figures using the "c.i.f" method (cost, including insurance and freight) for valuing imports. Publication of import data under the old f.a.s. (free alongside ship) definition is "withheld" for 48 hours and generally does not make the newspapers. (Between 1973 and 1979 both sets of data were published simultaneously.) With insurance and freight charges added in, imports naturally become larger (Chart 3). In the late 1970s, the annual difference in the import figures ran as high as six percent and in recent years has averaged slightly below five percent. For the trade balance itself, the difference is even more substantial (Table 1).

Congressional proponents of the c.i.f. valuation had long argued for its compilation, claiming as a major advantage that it would provide "more meaningful trade statistics in developing legislation and assessing our trade position." It was also argued that, with most other countries valuing their imports at the port of entry (c.i.f.), the United States was in a sense "undervaluing" its imports. But since the media report only the larger (and hence more unfavorable) set of data, it is easy for an *apparently* weaker trade balance to affect the dollar.

It is in fact misleading to link the monthly data too closely to the dollar. To the extent that freight and insurance on imports are provided by U.S. firms, they do not result in payments to foreigners. Even where shipping and insurance services are provided by foreign countries, in many cases these are not the same countries that are supplying the goods. Thus, only about 95 percent of the value of imports from a given country—recorded c.i.f.—may actually originate in that country.

By how much has the dollar actually fallen since its peak in February 1985 and, more pertinently, what is the most accurate way of measuring that decline? Probably no single measure can be entirely accurate, because of differences in country coverage, in the weights assigned to individual trading partners, and in adjustment for relative inflation rates.

As Morgan Guaranty Trust Company noted last fall, "Disappointment with the limited benefits of dollar depreciation so far has spawned a proliferation of novel exchange rate indices." A major point in the debate is that the dollar actually has fallen very little, and in a number of cases has even appreciated, against the currencies of some of our major trading partners, including Canada and several developing countries, such as Mexico, South Korea and Taiwan.

Table1
U.S. Trade Balance
(Billions of Dollars)

	C.i.f. basis	*F.a.s. basis*
1977	- 39.2	- 29.2
1978	- 42.4	- 31.1
1979	- 40.4	- 27.6
1980	- 36.4	- 24.2
1981	- 39.7	- 27.3
1982	- 42.7	- 31.8
1983	- 69.4	- 57.6
1984	-123.3	-107.9
1985	-148.5	-132.1
1986	-166.3	-152.7

Table 2
Ten Largest U.S. Bilateral Deficits
(Billions of dollars)

	1985	*1986*
Japan	-49.7	-58.6
Canada	-22.2	-23.3
Taiwan	-13.1	-15.8
Germany	-12.2	-15.6
Hong Kong	- 6.2	- 7.1
Mexico	- 5.8	- 5.2
Italy	- 5.8	- 6.5
Brazil	- 5.0	- 3.5
South Korea	- 4.8	- 7.1
United Kingdom	- 4.3	- 4.6

The Dollar and Major Industries

The best-known and most widely-used dollar exchange rate indexes have generally focused on those currencies that are traded most actively in international markets. But those currencies do not necessarily reflect the pattern of U.S. trade today. Some fifteen years ago, U.S. trade with the developing countries accounted for less than 30 percent of all U.S. trade and, on the import side, consisted largely of primary commodities. In 1986, by contrast, the LDCs accounted for about 34 percent of our trade and, more important, provided 26 percent of U.S. imports of manufactures.

Thus, the traditional indexes have excluded East Asian and Latin American countries, which have become important trading partners for the United States. Hong Kong, South Korea and Taiwan, for instance, are among the nine countries with which the United States had the largest bilateral trade deficits in the past two years (Table 2). Any index that did not include these countries might therefore generate overly optimistic expectations concerning improvement in the U.S. trade balance.

A recent effort to remedy this shortfall has been a comprehensive index, computed by the Federal Reserve Bank of Dallas, that encompasses 131 countries (and their currencies) and hence covers virtually all U.S. trade except with the Soviet Union. (It thus includes countries such as Costa Rica and Madagascar, whose total trade with the U.S. amounts to less than $100 million annually). This index registers a decline of less than three percent in the dollar from its peak in early 1985 to the end of last year.

Yet, as Morgan Guaranty has pointed out, it is not necessary to cover every single trading partner of the United States in order to come up with meaningful results. A much shorter list of some forty countries would account for almost 90 percent of total U.S. trade in 1985. A new dollar index, unveiled by Morgan last fall, includes the fifteen major industrial countries covered by the bank's traditional index, plus three additional industrial and 22 developing countries.

One major virtue of this broader index is that it is adjusted for relative inflation rates, which is of major importance once such countries as Brazil and Mexico are included. The index also attempts to measure U.S. international competitiveness—by assigning weights not only on the basis of U.S. bilateral trade in manufactures with a given country, but also in terms of the 38 remaining countries that compete in that country's domestic market. This index shows a drop of some 20 percent for the dollar between February 1985 and the end of 1986. It indicates that by early this year the dollar had fallen back to its average level during 1980-82 (Chart 4).

A somewhat different approach to tracking the impact of the weaker dollar on U.S. trade was taken early this year by Deborah Allen Olivier of the Claremont Economics Institute. Arguing that "how much a particular industry benefits from the dollar's depreciation depends critically upon the pattern of foreign competition for that industry," Olivier computed separate dollar indexes for seven major product categories and 33 subcategories. For each category, movements in the dollar were calculated relative to the currencies of the countries trading with the United States in that particular category. In the one-digit category "food and live animals," for instance, Japan accounts for 11 percent of U.S. trade, Canada for 10, Brazil for 6.8, and so on. Using these shares to weight changes in the dollar against those countries' currencies yielded a "food dollar" index that shows a 35 percent appreciation since early 1985.

On such a basis, none of the seven major product categories emerges more competitive in early 1987 than two years earlier. One might in fact conclude from this exercise that in real life there is no such thing as a

country's foreign trade, but that commercial transactions with other countries take place in numerous markets into which different currencies enter in various combinations and proportions. For instance, in the subcategory "passenger motor vehicles," the bulk of which come from Germany and Japan, the U.S. industry's position appears to have improved by some 23 percent.

However, these industry-specific calculations fail to tell us anything about changes in costs and prices abroad. This is not too serious in the case of the other major industrial countries, where inflation rates have not diverged significantly from the United States. But it creates problems for products traded largely with developing countries. Thus, for trade in coffee the dollar index shows a rise of 127 percent over the two-year period. That reflects, of course, the fact that the dollar has appreciated by some 127 percent on average against the currencies of our major suppliers of coffee, which have suffered astronomical inflation rates. It does not indicate, as a mere reading of the numbers might imply, that the U.S. "coffee industry" has become that much less competitive.

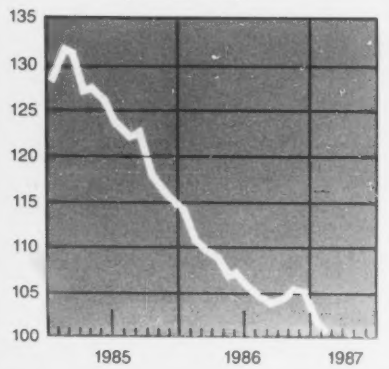
The Dollar Versus U.S. Trade

It is used to be axiomatic that a depreciating currency, after a suitable lag, would benefit a country's trade balance. Given that in two years the U.S. trade deficit appears to have responded little, if at all, to the decline in the dollar, it is perhaps time to revise that notion somewhat.

Chart 4

"Real Effective" Dollar Exchange Rate*

(1980-82 = 100)



*Change in dollar vis-a-vis 18 other industrial-country and 22 developing-country currencies, adjusted for relative inflation rates

First, there are some difficulties with accurately measuring how much the dollar has actually declined since early 1985. While the more comprehensive measures, such as that shown in Chart 4, point to a sizable fall, one can argue that not all of this combined currency effect will necessarily have a bearing on trading patterns. All broader indexes include countries such as Mexico and Venezuela, from which we import mainly oil. Such trade, as well as trade with many smaller countries whose currencies are used chiefly within their domestic economies, is dollar-denominated. The weights assigned to those currencies therefore overstate the importance of their rates vis-a-vis the dollar and distort their contribution to any broader index designed to measure U.S. competitiveness.

A second point that recently has entered the debate is that, to the American consumer at least, price may not be the sole determining factor in making a purchase. While some U.S. imports continue to come in simply because comparable U.S.-made goods are not available, for many others quality, style and status override price considerations. This applies to cars, textiles, a whole range of consumer goods, and various electronic gadgets—even at prices that might appear exaggerated.

Finally, the U.S. trade deficit would benefit vastly more if world economic growth became more robust than by any further dollar depreciation. It is true that the initial effects might be small: It has been estimated that if economic activity outside the U.S. grew by one percent, the U.S. trade balance would improve by some $10 billion per year. But faster growth abroad would also be welcome in the broader global context, expecially if it led to renewed investment and more buoyant economic activity in the developing world.

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